**Anniversaries:**

Nobody knew it at the time, but the Financial Crisis bottomed out on March 9th, 2009. Since we just passed its 7th year anniversary, we thought we would spend a little time to reflect on how far we have come. Since that day, the S&P 500 has gained nearly 150%. This bull market is now 84 months old, which makes it the 3rd longest stretch over the last century. Despite recent volatile periods in August, December and even January of this year, the market did not experience a bearish 20% decline. The average run of these bullish markets is 59 months, which makes this cycle roughly 2 years longer than normal. So the big question we often hear is "Are we significantly over-due for a correction or is this current environment likely to continue?"

The quick answer is - We don't know.

Before we look forward, let's take a step back. Following the crisis in 2007 to 2008, the Fed entered a period of easy monetary policy. Massive bond buying and near zero interest rates encouraged some investors to take on higher levels of risk. Pundits often call this a "risk on" strategy. This aggressive stimulus impacted the equity market, which reacted positively from early 2009 all the way through 2014.

Now fast forward to late 2014. The Fed began to signal that its easing policies were coming to an end. The market quickly embraced a "risk off" strategy and the equity markets started struggling. Companies with junk rated debt tumbled and the capital markets failed to steadily march higher. As the US dollar climbed, commodity prices fell. Once the Chinese government began to indicate a slowing growth profile, oil prices plummeted. With additional Middle East tensions added to the mix, the market experienced even higher levels of volatility. So, while last year was essentially flat for the equity markets, the first 10 trading days of January were the worst start to a year since 1897.

As we examined 4th quarter 2015 results (in January and February), we certainly noticed a few trends. The market seems to be struggling to deliver top line growth. Roughly 75% of companies in the S&P 500 exceeded earnings projections, but less than half beat their revenue expectations. Many companies are simply finding it difficult to grow and are attempting to cut costs to increase earnings. We understand that earnings can be flawed measures and that companies cannot cut their way to prosperity. This is why we target strong secular growth businesses with positive long-term opportunities.

**Volatility:**

Expectations for future results are a critical component of stock prices. As we have recently experienced, volatility for earnings estimates is quite wide. The stage is set for material surprises to future results. Through the first six weeks of the year, the S&P 500 posted 23 days



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of plus or minus 1% daily moves and five daily moves of plus or minus 2%. This is more than double that during the same time period last year.

Our long-term approach manages through these fickle markets. While the market swings between euphoric and pessimistic, we will stick to our investment philosophy. We conduct bottom's-up, fundamental research and manage weights on evolving risk / reward projections. We are business buyers and long-term investors, not short-term traders. Our core belief is that value is driven by time, not timing. It is during these periods of uncertainty and volatility that our time-tested approach to investing really shines.

**Interest Rates:**

Just a few months ago, the market was forecasting four interest rate hikes in 2016. According to the Fed's most recent announcement, officials are now only forecasting two. Over the next 1 to 2 years, Fed members (through their dot plots) are expecting the benchmark federal funds rate to be 1.875% by the end of 2017 and 3.0% by the end of 2018.

For quite some time, the Fed has been concerned with a lack of inflation – below its 2% threshold. The Fed likes to use an inflation measure called Core PCE (or core price consumption expenditures, which excludes food and energy prices). Back in 2012, The Fed suggested that given the structural slack in the labor markets (at near / full employment), it was comfortable to let the market run "hot". Last December, the Fed judged that our economy was ready for a move off zero rates (called ZIRP).

The world economy is truly correlated and we have been experiencing the cascading effects of this decision. Our central bank triggered global market actions, which have been fast and furious. There is a vicious cycle occurring. Fed members continue to discuss higher interest rates, which reflect low unemployment in the US, as well as modest levels of inflation. This leads to a strengthening US dollar and corresponding weakness in the Chinese Yuan. This triggers a global, central bank battle. The People's Bank of China draws down its foreign reserves to offset the Yuan outflows and to support trading. As we have recently experienced, this leads to higher US market volatility. With the European Central Bank following an easing strategy (bond buying and negative interest rates), one can see how this becomes a multi-faceted game of chess instead of just a simple game of checkers.

**Our opinion:**

We expect a measured and patient Fed to only raise rates when things are clear and markedly better. Zero interest rates were a result of the Financial Crisis and our economy no longer needs to be on "life support" measures. While we do not know what the Fed will ultimately do or how quickly it will respond to fluid global events, we feel comfortable that our portfolio will perform through this uncertainty. We are not expecting a US recession, but we do recognize



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that recessions are a consideration when investing. We focus on wisely and opportunistically investing while others may irrationally panic or emotionally sell. Once again, we believe value is driven by time, not necessarily timing.

We expect modest global growth - without inflationary pressures. Unlike many market experts, it is our belief that the market is still in a slow and steady recovery. Recessions come from excess, but we believe the US economy is still in an expansionary phase. In addition, we are modeling a longer band of lower commodity prices coupled with higher levels of market volatility. Can we be wrong? Absolutely! Will we be prepared to handle this uncertainty? Absolutely!

**Process:**

While it is important to understand the ramifications of this historic period, one of our key investment beliefs is to constantly understand and anticipate where the market is headed. We strive to look forward and understand where the markets are going. Drivers use their rear and side mirrors to guide their way, but one needs to look forward to see where you are headed and what lies ahead. We prefer to avoid consensus, to perform detailed valuation analysis and to adhere to our strict set of critical characteristics for investments.

As we discuss individual positions in our portfolios, you should always ask if we are sticking to our long-term philosophy. Do the companies mentioned below target strong secular growth opportunities? Do they possess high barriers to entry and a moat around their franchise? Are they market share leaders that have durable competitive advantages? Do these companies have pricing power and flexibility to withstand market volatility? Are their business models generating recurring revenue and sustainable free cash flow? Do the management teams properly allocate capital and do these companies have strong balance sheets and predictable free cash flow? The answer to all of these questions should be YES.

We attempt to build world-class portfolios that can handle very difficult times. When the capital markets are open for business and investors are embracing higher risk, there is an environment akin to “a rising tide lifts all boats”. However, without strong balance sheets or solid free cash flow, businesses tend to fail when their access to capital dries up. We strive to understand what happens to our companies when this rosy environment changes. When times get more difficult, our high quality companies and market share leaders tend to rise above their peers. We are constantly building models to test how our companies fare in the event of various scenarios. What are the ramifications of higher or lower interest rates? What will future revenue and earnings look like with commodity or energy price swings?

**Technology:**

The portfolio is heavily weighted between financials and technology companies. Within



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Technology, many of our companies benefit from the secular growth of digital payments. Unlike true "techy" businesses (software, hardware, cloud, etc.), these payment companies are not terribly at risk of rapid competitive threats or obsolescence. Some believe they should be categorized as financials since they often move money between various parties. Others feel they are consumer discretionary stocks. The specific sector classification is not as important as their wonderful characteristics and investment traits. These are transaction-based businesses that generate predictable, sustainable and recurring revenues and profits. Examples include Visa (ticker V), MasterCard (ticker MA) and PayPal (ticker PYPL).

These names are often referred to as "chicken tech", as they will benefit from the long-term migration from paper and check towards debit and credit transactions. Last year, 85% of global purchase transactions were still conducted in cash. While developed markets are at 59%, emerging markets are still conducting 92.7% of their total payment transactions in paper. Other positives are the over 2.5 billion people underserved by financial institutions and banks. In addition, millions of merchants are embracing cards and extending acceptance to new forms of payments (examples are Apple Pay or Samsung Pay). Lastly, new payment channels like bill payments and person-to-person remittances continue to grow rapidly. We believe the steady growth of digital payments will be measured in decades, not quarters.

**Financials:**
Unlike a traditional financial portfolio, we tend to be credit averse. The portfolio favors businesses that are both asset and volume sensitive. Taking a deeper dive into the positions is necessary, as this portfolio is specifically weighted towards companies that are transparent, free cash flow generative, as well as transaction based or toll keeper models. Inside the Financial sector, the portfolio does not own traditional banks, financial institutions, insurance companies or REIT's. It is positioned to capitalize on higher interest rates, as well as benefit from increased levels of market volatility. Some of our companies that will benefit from this environment are the derivative exchanges CME Group (ticker CME), Chicago Board Options Exchange (ticker CBOE) and Intercontinental Exchange (ticker ICE).

**1st Quarter 2016 Positives & Negatives:**
During the 1st quarter of 2016, some of our payment companies performed well. Specifically, Vantiv (ticker VNTV) contributed positively to performance, with gain of +14%. It is a well-capitalized and well-run merchant acquirer and processor, benefiting from the secular growth of digital payments. As the industry continues to consolidate, VNTV may be able to gain market share with its highly scalable payment platform and infrastructure. Another merchant acquirer, Global Payments (ticker GPN), recently reported excellent results and has seen its stock price rise by nearly 15% since the end of March. Last year, GPN experienced stock price appreciation of 60%, as the market began to appreciate the rapid growth of its international card business.



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One laggard this quarter was WisdomTree (ticker WETF), which was down over 20%. Despite being the smallest position in the portfolio, this type of dramatic decline can impact performance. WETF specializes in ETF's and attempts to hedge the currency declines that tend to impact international markets. This asset manager has a fairly predictable business model and excellent long-term prospects, but it was not immune to the market's wild swings and volatility. In addition, the reversal of expectations for US interest rates impacted Charles Schwab (ticker SCHW), as it fell 15% last quarter. This online brokerage benefits from higher volatility (more trading) and increased interest rates (better yields), but the stock underperformed with this change in market sentiment. The franchise is strong, it generates excellent free cash and the prospects looking forward appear very promising. The only thing that changed is the timing of higher rates. It becomes a question of when, not if rates rise. As the stock declined, we added to our position.

**New products:**

During the quarter, Manole Capital took the opportunity to launch three new products. The first is called "Pure Payments" and it is a concentrated portfolio of companies directly benefiting from the secular growth of digital payments. The second new product is called "Non Traditional Financials" and it seeks to capture specific financial exposure without the normal credit sensitivity. Do these thematic approaches sound familiar? They both should, as these are a natural extension of our original "Fin Tech" product. Both new portfolios simply provide a more concentrated approach to each of these themes and sectors.

Another new product is a diversified portfolio of high quality growth companies. It is heavily weighted towards financials, technology and the healthcare sectors. While it is more diversified, it is not a "closet index" portfolio. It has an active share of 83%, which reflects the percentage of the portfolio that is not in the benchmark. Anything over 75% is considered to be an active product. We expect these companies to generate excess free cash flow capable of delivering an annual dividend yield exceeding 2%. With the 10-year Treasury at 1.8%, we find the growth characteristics of this portfolio and its healthy dividend yield particularly attractive.

**Performance:**

The S&P 500 is typically the best benchmark comparison for any large cap US equity portfolio. The "Fin Tech" portfolio outperformed this index by 4.7% last year. During the first quarter of this year, the portfolio underperformed by 1.7%. The XLF is typically the best benchmark comparison for financials and our "Fin Tech" portfolio is roughly half invested in that sector. Since its inception last year, it has outperformed the financial benchmark each and every quarter. During 2015, Fin Tech generated 4.1% of relative outperformance versus the XLF and it added another 4.6% last quarter. Performance remains positive versus either benchmark and we continue to believe our investment process and philosophy is poised to deliver alpha going forward.



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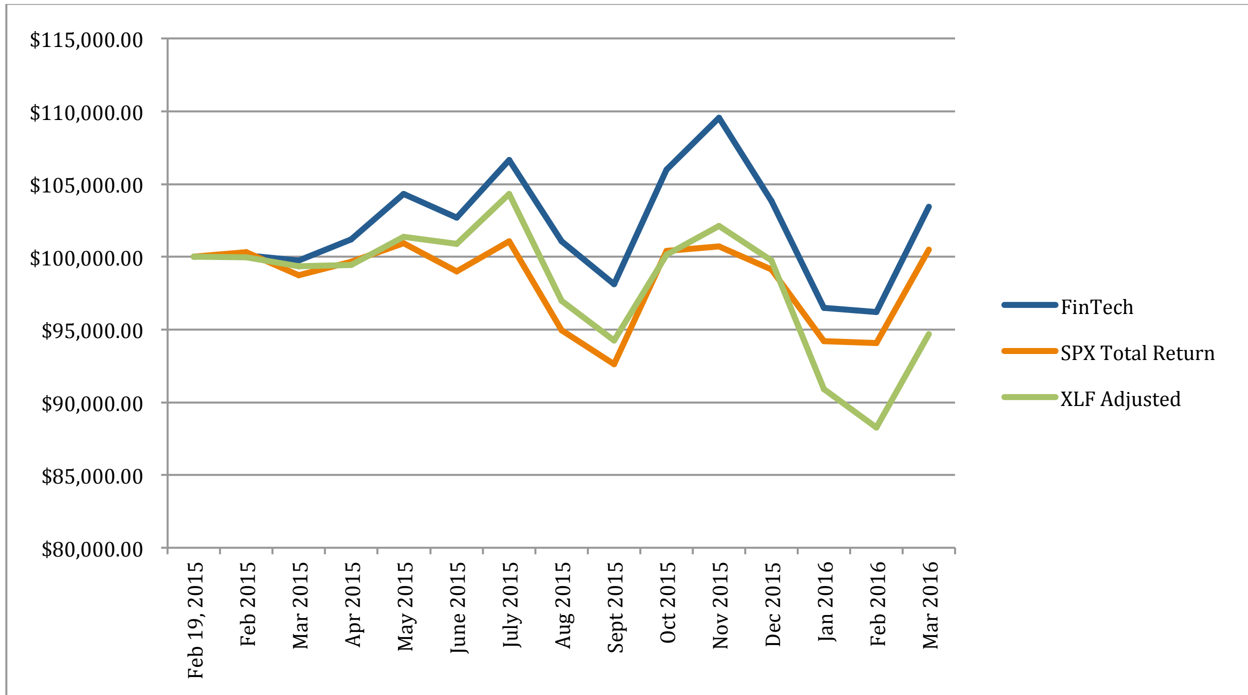


| Fintech | | Jan | Feb | Mar | Apr | May | June | July | Aug | Sept | Oct | Nov | Dec | YTD | Annualized Since Inception |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2015* | Gross [1] | | 0.09 | -0.33 | 1.47 | 3.08 | -1.57 | 3.88 | -5.25 | -2.94 | 8.04 | 3.35 | -5.18 | 3.86% | |
| | SPX | | 0.30 | -1.58 | 0.96 | 1.29 | -1.94 | 2.10 | -6.03 | -2.47 | 8.44 | 0.30 | -1.58 | -0.87% | |
| | XLF | | -0.04 | -0.62 | 0.08 | 1.95 | -0.46 | 3.40 | -7.06 | -2.81 | 6.27 | 1.99 | -2.36 | -0.28% | |
| 2016 | Gross [1] | -7.09 | -0.30 | 7.53 | | | | | | | | | | -0.40% | 2.95% |
| | SPX | -4.96 | -0.13 | 6.78 | | | | | | | | | | 1.35% | 0.40% |
| | XLF | -8.85 | -2.90 | 7.27 | | | | | | | | | | -5.07% | -4.59% |

* Partial period beginning on February 19, 2015.

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